Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:SD:TL-N-1053-99
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date: APR 23 1999

to: Examination Division, Laguna Niguel
ATTN: Pam Douglas, International Examiner, SP:1410

from: Associate District Counsel, Southern California District, San Diego

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subject: [redacted]
Conversion of Accounts Payable to Equity

This memorandum responds to your request for advice regarding whether, for the taxable year ending [redacted], and the short-year ending [redacted], the Service should impute interest pursuant to I.R.C. § 482 on "overaged" accounts payable due from [redacted] (the "Taxpayer") to its parent and whether the amounts imputed under I.R.C. § 482 are subject to withholding under I.R.C. §§ 1441 and 1442.

DISCLOSURE STATEMENT

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This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUES

1. Whether the Service may impute interest, pursuant to I.R.C. § 482, on amounts due from the Taxpayer to its sole shareholder, [redacted], an Israeli corporation, as a result of purchases in the ordinary course of business, where (1) the Taxpayer is not required to pay the amounts due by any specified date and (2) the Taxpayer is not required to pay any interest on the amounts due for the period during which the amounts are outstanding.

2. Whether the Taxpayer is liable for withholding tax, pursuant to I.R.C. §§ 1442 and 1461, for interest imputed pursuant to I.R.C. § 482.

3. Whether the Taxpayer is liable for withholding tax, pursuant to I.R.C. §§ 1442 and 1461, for deemed/constructive payments of interest on the conversion to equity of the amounts due from the Taxpayer to [redacted].

4. Whether the Service should examine the Taxpayer's taxable year ending [redacted], and assert similar adjustments to those described in Issues 1, 2, and 3.

CONCLUSIONS

1. Yes. [redacted] did not charge the Taxpayer interest on the amounts due from the Taxpayer. Under I.R.C. § 482, the Service is authorized to allocate income between these parties in order to reflect an arm's length rate of interest for the use of the amounts outstanding.

2. Yes. We take the position that the Taxpayer need not make an actual payment of interest for I.R.C. § 1442 to apply.

3. Yes. In the Ninth Circuit, the forgiveness of accrued but unpaid interest for stock constitutes a payment of such interest. As such, the payment is subject to the withholding requirements of I.R.C. § 1442. In this case, the Service first must determine what portion of the accounts payable converted to equity constitutes accrued but unpaid interest.

4. Assuming that the facts with respect to [redacted] are substantially similar to those with respect to [redacted], the Service would be authorized to impute interest on the outstanding balance of the accounts payable under I.R.C. § 482 and to impose withholding tax under I.R.C. § 1442. The Service also would have a basis for imposing withholding tax with respect to the portion of accounts payable converted to equity that is treated as accrued but unpaid interest.

FACTS

[redacted] (the "Taxpayer") is a California corporation wholly owned by [redacted] (the "Parent"), an Israeli corporation. Prior to [redacted], the Taxpayer

used the fiscal year ending [redacted] as its taxable year. As of [redacted], the Taxpayer uses a calendar year as its taxable year.

The Parent did not conduct any trade or business within the United States during [redacted].

Prior to [redacted], the Taxpayer manufactured and sold [redacted] at the wholesale level to retail outlets and warehouse clubs throughout the United States. The [redacted] manufactured by the Taxpayer had a special [redacted] coating that it purchased from the Parent. Generally, the Taxpayer paid the Parent between $[redacted] and $[redacted] per kilo for the [redacted].

In [redacted], Chinese manufacturers entered the U.S. market offering [redacted] similar to those sold by the Taxpayer but at a cheaper price. As a consequence, the Taxpayer could not sell as many [redacted] and ended [redacted] with large inventories. In [redacted], the Taxpayer ceased manufacturing [redacted] and became an importer of [redacted].

It is our understanding that the Parent did not set any terms for payment on the sale of its [redacted]. That is, the Taxpayer made payments to the Parent only when it had the funds to do so. It is our understanding that the Taxpayer made very few payments on the accounts payable. The Service is going to confirm this understanding.

The Taxpayer treated the accounts payable resulting from the purchases from the Parent as an "obligation on which no interest was charged by the parent." See letter dated [redacted], from [redacted], the Taxpayer's representative, to the Service.

The following table shows the purchases made by the Taxpayer and the outstanding balance at the close of the year:

Year Ending	Purchases	Accounts Payable
[redacted]	$[redacted]	$[redacted]

See the Taxpayer's Financial Statements for years ended [redacted] through [redacted].

On occasion, the Parent made capital contributions to the Taxpayer. The following table shows the capital contributions made by the Parent:

Year Ending	Contribution	Number of Shares
[redacted]	$[redacted]	[redacted]

The Service represents that each contribution was a conversion of accounts payable to equity. However, we could only independently verify that the contribution made in [redacted] was a conversion of accounts payable to equity. See Resolution Adopted by Unanimous Written Consent of Board of Directors of [redacted] dated [redacted]

During the [redacted] quarter of [redacted], the Taxpayer reached an agreement with the Parent for an adjustment to the purchase price for the [redacted] such that the Taxpayer only owed the Parent $[redacted] per kilo for that year. The Parent, therefore, granted the Taxpayer a credit of $[redacted]. See the Taxpayer's Financial Statement for the years ended [redacted] and [redacted]

Also, we note that the Taxpayer makes numerous "reversals," "cancellations," and other adjustments to its accounts payable. For example, on [redacted], the Taxpayer credited its accounts payable in the amount of $[redacted] for invoice #[redacted] but on [redacted] it debited its accounts payable in the amount of $[redacted] for invoice #[redacted] and credited its accounts payable in the amount of $[redacted] for that invoice. Also, on [redacted], the Taxpayer credited its accounts payable in the amount of $[redacted] for invoice # [redacted], but, on [redacted], it "canceled" the invoice and debited its accounts payable by $[redacted]. It is unclear, at this stage, why the Taxpayer made these "reversals," "cancellations," and other adjustments.

The Taxpayer reported no interest expense on its U.S. Corporation Income Tax Return, Form 1120, for fiscal year ended [redacted]. The Taxpayer also reported on Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation, that (1) it owed the Parent $[redacted] at the beginning of the taxable year and $[redacted] at the end of such year and (2) it purchased inventory of $[redacted].[1]

The Taxpayer reported no interest expense on its U.S. Corporation Income Tax Return, Form 1120, for the short-year ended [redacted]. The Taxpayer also reported on Form 5472 that (1) it owed the Parent $[redacted] at the beginning of the taxable year and $[redacted] at the end of such year and (2) it purchased inventory of $[redacted].

The Service is examining the Taxpayer's fiscal year ending [redacted], as well as the Taxpayer's short-year ending [redacted]. The Service proposes to impute interest

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[1] The Taxpayer used a fiscal year for tax purposes but used a calendar year for financial statement purposes. Therefore, the amount appearing on Form 5472 differs from the amount appearing in the financial statements.

on the "overaged" accounts payable pursuant to I.R.C. § 482 and to impose a liability for withholding tax pursuant to I.R.C. §§ 881 and 1442 on such imputed interest. The Service, however, does not identify the amount of the proposed imputed interest or the amount of the proposed withholding tax liability.

The Service is also considering examining the Taxpayer's taxable year ending [redacted]. The Service states that the Parent converted over $[redacted] in accounts payable to capital during this year. The Service has asked for advice regarding whether it should examine [redacted] to raise the issues proposed for [redacted].

DISCUSSION

I. APPLICATION OF I.R.C. § 482

I.R.C. § 482(a) authorizes the Service to distribute, apportion, or allocate gross income, deductions, credits, or allowances between controlled entities, if it determines that such distribution, apportionment, or allocation is necessary to prevent evasion of taxes or to clearly reflect the income of any of such controlled entities.

Specifically, the Service may make appropriate allocations to reflect an arm's length rate of interest for the use of funds, where one member of a controlled group makes an interest-free loan or a loan at less than an arm's length rate of interest to another member of the group. Treas. Reg. § 1.482-2(a)(1)(i). For this purpose, an indebtedness arising in the ordinary course of business from sales between members of the controlled group (an "intercompany trade receivable") is considered a loan between members of a controlled group. Treas. Reg. § 1.482-2(a)(1)(ii)(A)(2).

The term "arm's length rate of interest" means a rate of interest which was charged, or would have been charged, at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances. Treas. Reg. § 1.482-2(a)(2). Treasury Regulation § 1.482-2(a)(2) provides "safe haven" interest rates based an the applicable Federal rate.[2]

Generally, the period for which interest is charged with respect to bona fide indebtedness between controlled entities begins on the day after the indebtedness arises and ends on the day that the indebtedness is satisfied. Treas. Reg. § 1.482-2(a)(1)(iii)(A). The period for which interest is charged with respect to an intercompany trade receivable, however, begins on the first day of the third calendar month following the month in which the intercompany trade receivable arises. Treas. Reg. § 1.482-2(a)(1)(iii)(B).

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[2] Because the Taxpayer was not charged interest on its outstanding accounts payable, we do not find it necessary to discuss in detail the safe haven rates.

In this case, the Taxpayer purchased [redacted] from its Parent and incurred an indebtedness associated with such purchases for which it was not charged any interest. This scenario falls squarely within the purview of I.R.C. § 482.[3,4] As such, the Service may impute interest to the Parent on the amounts due from the Taxpayer pursuant to I.R.C. § 482 and the regulations thereunder. The Service, however, should keep in mind that the Taxpayer is entitled to an interest-free period of 60 to 90 days pursuant to Treasury Regulation § 1.482-2(a)(1)(iii)(B).

We see three potential problems in calculating the interest to be imputed during [redacted]. First, the Service must account for the interest-free period described in Treasury Regulation § 1.482-2(a)(1)(iii)(B). As stated above, interest is not required to be charged on an intercompany trade receivable until the first day of the third calendar month following the month in which the intercompany trade receivable arises. For example, interest on an intercompany trade receivable arising in December 1995 is not required to be charged until March 1, 1996. We recommend that the Service take the following steps:

1. determine the outstanding balance of accounts payable as of [redacted];
2. impute interest on this amount beginning on [redacted];
3. determine the total purchases made for each month after [redacted];
4. impute interest on these amounts in accordance with Treas. Reg. § 1.482-2(a)(1)(iii)(B).

The Service should account for any payments, if any, made by the Taxpayer as appropriate.

Second, the Service must account for "reversals" and other adjustments to the accounts payable. According to the "general ledger detail report," the Taxpayer debited its account payable repeatedly for "reversals" of invoices, "cancellations" of invoices, and other similar events. For example, on [redacted], the Taxpayer credited its accounts payable in the amount of $[redacted] for invoice #[redacted], but on [redacted], it debited its accounts payable in the amount of $[redacted] for invoice #[redacted] and credited its accounts payable in the amount of $[redacted] for that invoice. Also, on [redacted], the Taxpayer credited its accounts

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[3] I.R.C. § 7872 does not apply to the facts of this case. Treasury Regulation § 1.7872-5T(c)(2) provides that "section 7872 shall not apply to a below-market loan . . . if the lender is a foreign person and the borrower is a U.S. person unless the interest income imputed to the foreign lender . . . would be effectively connected with the conduct of a U.S. trade or business . . . and not exempt from U.S. income taxation under an applicable income tax treaty." In this case, the Parent did not conduct a trade or business in the United States during [redacted]

[4] I.R.C. § 483 does not apply to the facts of this case. Generally, I.R.C. § 483 applies to payments made under a contract for the sale of property, where all or part of the sales price is due more than 6 months after the date of sale and where some or all of the payments are due more than 1 year after the date of sale. I.R.C. § 483, however, does not apply to below-market demand loans between a corporation and its shareholder. In this case, the Parent does not set a due date for payment on the purchase of [redacted] The resulting accounts payable are akin to demand loans, and as such, are not subject to the rules of I.R.C. § 483.

payable in the amount of $[redacted] for invoice # [redacted], but, on [redacted], it "canceled" the invoice and debited its accounts payable by $[redacted].

Third, the Service must address the price adjustment to which the Taxpayer and the Parent agreed during the [redacted] quarter of [redacted]. The parties intended the price adjustment to apply retroactively and to the entire year. See the Taxpayer's Financial Statements for the years ended [redacted] and [redacted]. As a consequence, the Service must compute the accounts payable using the revised price. The Service should not simply give the Taxpayer credit as of [redacted], the date on which the Parent gave the Taxpayer credit pursuant to their agreement.

II. APPLICATION OF I.R.C. §§ 881 AND 1442 TO IMPUTED INTEREST

I.R.C. § 881 imposes a tax of 30 percent of the amount received from sources with the United States by a foreign corporation as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income, but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.

I.R.C. § 1442 provides that, in the case of foreign corporations, "there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in [I.R.C. §] 1441 a tax equal to 30 percent thereof." I.R.C. § 1441 requires all persons, in whatever capacity, having control, receipt, custody, disposal, or payment of any items of income specified in I.R.C. § 881 to deduct and withhold from such items a tax equal to 30 percent. In this case, the rate of 30 percent is reduced by the income tax treaty between Israel and the United States to 17.5 percent. See Income Tax Treaty Between Israel and the United States (1975), Article 13, Interest; see also Treas. Reg. § 1.1441-6(a).

I.R.C. § 1461 provides that every person required to deduct and withhold any tax under I.R.C. §§ 1441 and 1442 is liable for such tax and is indemnified against the claims and demands of any person for the amount of any payments made in accordance with I.R.C. §§ 1441 and 1442.

In this case, the Taxpayer has not made an actual payment of interest to the Parent. Arguably, however, the Taxpayer need not make an actual payment for I.R.C. §§ 881, 1441 and 1442 to apply.

The Tax Court has held that I.R.C. § 881 does not require actual payment of the income item and that the allocation of income pursuant to I.R.C. § 482 provided a sufficient basis for imposing the tax under I.R.C. § 881. See Central de Gas de Chihuahua v. Commissioner, 102 T.C. 515 (1994).

The Tax Court, however, expressly did not reach the issue of whether there was a requirement for actual payment for purposes of I.R.C. §§ 1441 and 1442. The Court

distinguished between I.R.C. § 881, which imposes a liability for tax, and I.R.C. §§ 1441 and 1442, which provides the means for collecting that tax, and noted that these sections served distinctly separate purposes. Nonetheless, we take the position that this case supports subjecting interest imputed under I.R.C. § 482 to the withholding requirements of I.R.C. §§ 1441 and 1442. As stated above, the case stands for the proposition that an amount allocated under I.R.C. § 482 is deemed received by the foreign entity and is subject to tax under I.R.C. § 881. If I.R.C. §§ 1441 and 1442 are the means to collect on this tax, the amount so allocated should be deemed received for their purposes. To find otherwise would render ineffective the liability imposed by I.R.C. § 881. The Tax Court touched on this concern when it observed that "[a] holding that actual payment is required could significantly undermine the effectiveness of § 482 where foreign corporations are involved. Such a view would permit such corporations to utilize property in the United States without payment for such use and thereby avoid any liability under § 881." Id. at 520.

In addition to Central de Gas, we look to two other cases in support of our position that actual payment is not needed for I.R.C. §§ 1441 and 1442 to apply: Climaco and Nakamura v. Internal Revenue Service, 96-1 USTC ¶ 50,153 (E.D.N.Y. 1996) (unpublished opinion, Jan. 24, 1996) and Casa de la Jolla Park, Inc. v. Commissioner, 94 T.C. 384 (1990). In Climaco, the District Court held that the plaintiffs were required to withhold and pay a portion of the interest imputed pursuant to I.R.C. § 7872 even though they did not actually make any interest payments on the loan. The court could not discern any reason why the plaintiffs should not be required to make withholding payments. Climaco, 96-1 USTC ¶ 50,153. In Casa de la Jolla, the Tax Court rejected the petitioner's argument that I.R.C. § 1441 requires actual payment and receipt, stating that the language of I.R.C. § 1441 "contemplates imposing responsibility on a broad spectrum of persons: 'all persons, in whatever capacity acting . . . having the control, receipt, custody, disposal, or payment.'" Casa de la Jolla, 94 T.C. at 392-393 (quoting I.R.C. § 1441(a))(emphasis supplied).

Finally, we note that Treasury Regulation § 1.1441-2(e)(2) addresses the issue described above. Specifically, it provides

> A payment is considered made to the extent income subject to withholding is allocated under section 482. Further, income arising as a result of a secondary adjustment made in conjunction with a reallocation of income under section 482 from a foreign person to a related U.S. person is considered paid to a foreign person .

Treas. Reg. § 1.1441-2(e)(2). While this regulation is not yet effective and, therefore, does not apply to the taxable years in this case, it does represent a position consistent with current applicable law on this point.[5]

III. APPLICATION OF I.R.C. §§ 881 AND 1442 TO CONVERSION

During [redacted], the Parent converted $[redacted] of the accounts payable due from the Taxpayer into [redacted] shares of stock in the Taxpayer. Arguably, the Taxpayer, in essence, paid the Parent $[redacted] in satisfaction of a portion of the amounts due to the Parent, and the Parent immediately contributed this payment back to the Taxpayer in exchange for additional stock. If the amount converted to equity is treated as a payment of the amounts due, then a portion of the amount converted should be treated as a payment of interest. See Treas. Reg. § 1.446-2 ("[E]ach payment under a loan . . . is treated as a payment of interest to the extent of the accrued and unpaid interest."); see also Estate of Ratliff v. Commissioner, 101 T.C. 276 (1993) and cases cited therein. And if a portion of the payment is treated as a payment of interest, such portion is subject to withholding under I.R.C. §§ 1441 and 1442.

We find that, in the Ninth Circuit, this argument has merit. See Fender Sales, Inc. v. Commissioner, 338 F.2d 924 (9th Cir. 1964), rev'g T.C. Memo. 1963-119. In Fender Sales, a corporation was indebted to its two shareholders for accrued but unpaid salaries. The corporation discharged the debt by issuing additional shares to the shareholders. The Ninth Circuit found that the transaction constituted a payment of salary to those individuals. In our case, the Taxpayer was indebted to the Parent for accrued but unpaid interest. The Taxpayer discharged this debt by issuing additional shares of stock to the Parent. In the Ninth Circuit's view, this transaction constituted a payment of interest to the Parent.

The Tax Court, however, has questioned and expressly not followed the reasoning of the Ninth Circuit in Fender Sales. See Putoma Corp. v. Commissioner, 66 T.C. 652 (1976), aff'd, 601 F.2d 734 (5th Cir. 1979). Nonetheless, the Service should continue to pursue the arguments made in Fender Sales where, as here, the Golsen rule would compel the Tax Court to follow the holding in Fender Sales. See Golsen v. Commissioner, 54 T.C. 742 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971).

In applying I.R.C. §§ 1441 and 1442, the Service should take steps to avoid taxing twice the interest on the amounts due from the Taxpayer, once for interest imputed under I.R.C. § 482 and again for interest treated as paid pursuant to Fender Sales.

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[5] Neither the preamble to the regulation nor the regulation itself indicates that the regulation was intended to reflect a change in the Service's position.

If you have any questions, please call the undersigned at (619) 557-6014.

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Attachment

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